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SUBJECT: UKRAINE'S NATIONAL BANK WILL HELP WITH GAS PAYMENTS

Classified By: Ambassador John F. Tefft for Reasons 1.4 (b) and (d)

¶1. (C) Summary. Despite the lack of political unity, the National Bank of Ukraine was obliged to help the government make its gas payments to Russia in a timely manner, National Bank Governor Stelmakh told the Ambassador on January 14. During the meeting, Stelmakh also noted that the exchange rate had been under pressure of depreciation recently as a result of political uncertainty and banks engaging in speculation. Nonetheless, he expressed confidence in the National Bank of Ukraine's monetary policy, particularly its success in holding down inflation over the past year. Nadra Bank would be brought back to life quickly if creditors would only agree to a stiff financial haircut. End Summary

Stelmakh Complains of Lack of Political Unity

¶2. (C) Disharmony between Ukraine's President and Prime Minister had a negative impact on Ukraine's economy, National Bank Governor Volodymyr Stelmakh told the Ambassador on January 14. Conducting monetary policy was difficult. Stelmakh complained that as a result of political infighting, the National Bank of Ukraine (NBU) lacked access to basic statistics, including budget deficit and GDP figures. Business was difficult. The government, for example, owed businessmen UAH 17 - 22 billion (\$2.1-\$2.75 billion) in VAT arrears, according to Stelmakh. And the economy continued to suffer generally from the government's inability to address the economic crisis in a unified manner.

Gas Payments Continue to be Problematic but Will Be Made

¶3. (C) Gas payments were also a problem. Stelmakh confirmed that the National Bank made the decision in December to "provide for these problems" although doing so violated the Bank's standard operating procedures. Expressing a sense of responsibility for facilitating gas payments, Stelmakh noted that the NBU was obligated to be involved since the IMF loan was intended to support Ukraine's balance of payments and gas payments constitute an important balance of payments line item.

¶4. (C) Stelmakh confirmed that the NBU monetized \$900 million in early January from reserves to help the government make the January 11 gas payment. The NBU ensured, however, that it used accounts within the National Bank itself to enact the payment. Stelmakh wanted to guarantee that neither Naftohaz nor the GOU could touch the money before it was transferred to Gazprom out of concern that the funds would be used for domestic obligations instead. The transaction was finalized on January 6, according to Stelmakh. Stelmakh criticized Russia for trying to use Ukraine's difficulties making the

payments to discredit Ukraine at every turn. He also stated that, although Ukraine was in discussions with Russia about schemes for making the February and March gas payments, he doubted that the Russians would come through in any way. Ukraine hoped that Russia would allow Ukraine's gas payment to be offset by advance gas transit fees or provide loans. Stelmakh stated categorically, however, that gas payments, which would be lower in February and March, would be made. He did not state specifically how they would be made but said that the NBU was obliged to be involved.

15. (C) Clearly unhappy that the NBU had not been the recipient of all IMF program money to Ukraine, Stelmakh asserted that the IMF program was actually operating in violation of Ukrainian law. He stated that of the \$10.6 billion the Ukraine already received from the IMF, \$4.9 billion had gone directly to the Government of Ukraine to pay domestic obligations. Stelmakh claimed that any debt burden taken on by the government should first have the approval of the Ukrainian parliament. However, Tymoshenko's government had not sought parliamentary approval. Stelmakh also maintained that the money the government had earned from selling Kyoto carbon credits had gone directly to the budget, rather than into "green" programs as intended.

NBU Successfully Held Inflation Low

16. (C) With pride, Stelmakh reported that the NBU was able to lower inflation from 22% to 12% in 2009, despite severe GDP contraction, which he estimated at 18%, a drop in

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exports, and a large government deficit. Stelmakh believed that the low inflation rate showed that the NBU's monetary policy was "correct."

Exchange Rate Intervention but Banks Pushing Rate Lower

17. (C) The National Bank continued to intervene in the currency markets to support the national currency (the hryvnia). However, Stelmakh complained that the NBU's ability to intervene was limited because half of the IMF loan had gone directly to the GOU for budgetary support instead of to the NBU for balance of payments support. In recent days, Stelmakh thought currency depreciation was being driven by psychological factors in advance of the elections. He lamented the ability of the media to whip up panic and drive down the exchange rate. Stelmakh also said that the NBU was seeking to consult with banks that were coming in with low bids for currency. Stelmakh said, for example, that Citibank had bid for currency at 8.25 when the official exchange rate was hovering closer to 8.0. These bids had reportedly caught the NBU off guard as it had spent \$725 million in December and another \$25 million during the first week in January in support of the hryvnia. Stelmakh hypothesized that banks were looking to make some money on currency speculation since lending was still basically frozen. The NBU was considering suggesting new regulations that would require banks found to be speculating on the exchange rate to repay any NBU recapitalization funds they may have received. (Note: Citibank told Econoff on 1/15 that it and other banks had received a harsh letter from the NBU threatening to hold CEOs of banks personally liable for foreign exchange transactions and any impact of a devaluation on the economy. For its part, Citibank believes the downward pressure on the hryvnia is primarily a function of high demand from the population for foreign currency given the politically unstable period. End note.)

Nadra Bank

18. (C) Expressing concern about the health of the banking system, the Ambassador noted that U.S. export credit agencies

had interests as creditors in Nadra Bank and asked about efforts to address the problems at Nadra and in the sector. In response, Stelmakh said that Nadra was among the first group of banks to be recapitalized; however, a conflict of interests between its owners and the Prime Minister had stalled a full workout. He was aware that foreign firms (including Cargill) and foreign export credit agencies were interested in restructuring their loans to Nadra. The talks with creditors were ongoing and not easy, according to Stelmakh. Creditors were now being offered a package which would require a 60% write-off, restructuring of 30% over the next 3-7 years, and a 10% cash payment. But Stelmakh thought that Nadra couldn't even come up with the 10% cash payment. If the creditors agreed, Stelmakh thought the bank would come back to life within 2-3 months, and he expressed willingness to continue negotiations with the creditors. In general, Stelmakh thought that the banking system was in better shape than in was a year ago as banks had been required to increase their reserves.

Ukraine Shifting out of G-7 Currencies

¶9. (C) Prior to the IMF program, Ukraine had its reserves invested in a broad range of stable but relatively high yielding currencies and short-term bonds, according to Stelmakh. However, the IMF has recommended that Ukraine hold its reserves in G-7 country instruments only. As a result, Stelmakh said the NBU was buying more U.S. T-bills and selling off Norwegian and Danish currency-denominated instruments, among others. Stelmakh complained that this would mean lower returns on NBU reserves but said the IMF required such a move.

COMMENT: NBU Chief in Precarious Position

¶10. (C) Although NBU Governor Stelmakh said at the beginning of the meeting that the National Bank was not a political organization and that he tried to pay little attention to the issues surrounding Ukraine's election, he is at the center of one of Ukraine's most heated political conflicts between

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Prime Minister Tymoshenko and President Yushchenko. So far, he has remained a strong Yushchenko supporter and resisted monetizing much of the government's domestic debt. However, realizing the necessity of meeting Ukraine's international obligations, he (with the President's acquiescence) has made it clear that as a last resort the NBU will do what it takes to help the government with gas payments over the next few months. End Comment.

TEFFT